In the Matter of the Application regarding the Conversion of Premera Blue Cross and its Affiliates

Washington State Insurance Commissioner: Docket No. G02-45

REPORT OF

E. Lewis Reid

November 10, 2003

Background of this Report

I have been retained as a consultant[1] by PREMERA, a Washington miscellaneous nonprofit corporation ("PREMERA"), Premera Blue Cross, a Washington nonprofit corporation ("PBC"), and certain of their affiliates (collectively "Premera") to provide a report to Premera in connection with Premera's proposal to convert from nonprofit to for-profit status, and to create two charitable foundations to serve unmet health needs in Washington and Alaska (the "Conversion Transaction"). This report will comment upon the Premera proposal and upon certain of the matters and conclusions contained in reports previously filed by consultants engaged by the staff of the Washington State Office of Insurance Commissioner (the "OIC Staff").

I was formerly President and CEO of The California Endowment, the largest private foundation created in a Blue Cross or Blue Shield conversion, and continue to serve on its Board of Directors at this time. Prior to joining The California Endowment in 1998 I was an attorney in San Francisco and was counsel to Blue Cross of California in its 1996 conversion to for-profit status. My clients also included The California Endowment, the California HealthCare Foundation, the Alliance HealthCare Foundation and the Sierra Health Foundation, all foundations created in the conversion of nonprofit health organizations to for-profit status.

In preparing this report, I have reviewed the following[2]:

- Premera's Form A and Exhibits filed with the OIC;
- Cantilo & Bennett LLP Final Report to the OIC dated October 27, 2003 ("Cantilo & Bennett");
- The Blackstone Group *Report on Valuation and Fairness of the Proposed Conversion* dated October 27, 2003 ("Blackstone"); and
- PricewaterhouseCoopers ("PwC") *Report to the Washington State, Office of Insurance Commissioner on Tax Matters in Connection with the Proposed Conversion of Premera* dated October 27, 2003 ("PwC Tax Report").

Executive Summary

The Conversion Transaction serves the public interest by permitting Premera to continue as a vital company with access to the capital markets, while unlocking the charitable potential in its assets by adding two new large sources of philanthropic health funding in the states of Washington and Alaska. The burst of health philanthropy from conversions in other states has addressed needs not easily solved either by government or by

[1] I have been retained solely as a consultant and am not acting as legal counsel for any party in this proceeding.

[2] I have also reviewed various reports submitted to the Alaska Division of Insurance. I expect to address reports by ADI consultants in a report to be filed in the ADI proceedings.

traditional health insurers, including issues raised by the millions of uninsured residents, the health status of ethnic minorities, lack of funding for community mental health systems, and rising costs limiting the availability of health care in rural areas and rural hospitals. The structure of the Proposed Transaction will maximize the potential economic benefit to charities by minimizing the taxes incurred in the process of realizing the value of the initial stock of New PREMERA issued to the Foundation Shareholder and transferring the proceeds to the Charitable Organizations.

Report

1. The Proposed Conversion Transaction Serves the Broad Public Interest.

At the present time, the entire value of Premera is held in its taxable nonprofit corporate structure. When the Conversion Transaction has been closed, the sale of all of the stock of New PREMERA initially distributed to the Foundation Shareholder has been completed, and the proceeds have been distributed to the Charitable Organizations, Alaska and Washington will have two large charitable organizations dedicated to improving health in those states.

As a consequence of the health care conversions over the past fifteen years, there has been a burst of new health philanthropy in the United States. The health foundations created in the conversion of Blue Cross/Blue Shield and other health care organizations to for-profit entities have addressed needs not easily solved either by government or by traditional health insurers. For example, I am aware from my experience as President & CEO and a board member of The California Endowment that at a time when government funding is tight:

- Millions of our residents are uninsured;
- Only a fraction of the persons eligible for Medicaid coverage are enrolled;
- Only a fraction of the children eligible for federally funded CHIP coverage are enrolled;
- Undocumented immigrants have health care needs but are largely left outside our health care delivery system;
- The uninsured often use hospital emergency rooms as their primary care resource, driving up the operating costs for hospitals in a particularly inefficient allocation of resources;
- The safety net for the uninsured and particularly the community clinic system are under dire economic stress;

- Financial support and technical assistance to community-based organizations are needed to strengthen the safety net;
- Significant disparities in the health status of ethnic minorities exist, particularly in diseases such as diabetes and asthma;
- Community mental health systems are generally inadequate and under-funded;
- Independent forums for convening all of the interested parties in our health care systems need to be expanded;
- The demographics of our aging population will pose severe challenges to our health systems in coming decades;
- Rising costs are limiting the availability of health care in rural areas, and rural hospitals and clinics are under particular stress;
- Unhealthy behaviors such as smoking, bad diet, alcohol and drug problems, lack of exercise, and unsafe sex severely degrade the health status of our communities and impose massive health care costs on society;
- Dental care is inadequate in many rural populations; and
- There is a need for more health care workers, especially nurses, and for the health care work force to be more diverse.

All of these, and many more, issues are being addressed by the growth of health philanthropy from conversions in other states. In California for example, The California Endowment received approximately $3.0 billion in proceeds from the conversion of Blue Cross of California. That endowment has enabled it to make charitable distributions of $150 million to $200 million a year to address problems such as those listed above. The foundations created by the Premera Conversion Transaction may not be as large as The California Endowment. However, if the amount realized by the Charitable Organizations were to be in the range of $500 million to $600 million, the amount per capita available to health philanthropy in Washington and Alaska would be roughly equivalent to that available in California from The California Endowment, the largest foundation ever created in a Blue Cross/Blue Shield conversion.[3] By focusing their efforts solely on Washington and Alaska, the Charitable Organizations can potentially have a greater per capita influence on health in these two states than the $8 billion Robert Wood Johnson Foundation located in New Jersey, the largest health-related private foundation in the

[3] This statement is based upon the 2001 census, which reports that California's population is 34,501,130, Washington's population is 5,984,973 and Alaska's population is 634,892.

country, which conducts health-related charitable programs throughout the United States.[4]

Cantilo & Bennett urge that the Commissioner "should not give significant weight to PREMERA's implication that the purported benefits of the Foundation Shareholder and the Charitable Organizations will offset the negative impact of the conversion."[5] The potential size alone of these two proposed Charitable Organizations demands the Commissioner's consideration. Given the practice of charities to pursue programs that leverage their assets for greater social impact, their influence could well be much greater than the size of their endowments. The benefits of the Charitable Organizations to residents of Washington and Alaska are so profound that they may not be ignored.

Thus, the Conversion Transaction would serve the public interest by permitting Premera to continue as a vital company with access to the capital markets, while unlocking the charitable potential in its assets by adding two new large sources of philanthropic health funding in the states of Washington and Alaska.

2. *Section 501(m) of the Internal Revenue Code Has Been a Significant Driver of Blue Cross/Blue Shield Conversions.*

The first conversion of a Blue Cross/Blue Shield entity occurred in 1996, two years after the licensing entity, the Blue Cross and Blue Shield Association ("BCBSA"), amended its rules to permit stock companies to hold Blue Cross/Blue Shield licenses, and ten years after the occurrence of the main driving force behind the conversions. The principal force that created the trend over the past decade for Blue Cross/Blue Shield plans to convert to for-profit status was an action taken by Congress in 1986.

Cantilo & Bennett briefly recount the history of the Blue Cross/Blue Shield movement in America, moving from its infancy in the 1930s through consolidation in the 1980s then directly to 1994 when the BCBSA first permitted its licensees to be organized as for-profit stock companies. "Lured perhaps by the ability to 'cash in' on this long-developed franchise,"[6] they say, the BCBSA permitted its members to convert to for-profit companies. The most important step in the path toward Blue conversions is missing from this account. Prior to 1986, all Blue Cross/Blue Shield organizations were federally tax-exempt as either 501(c)(3) or 501(c)(4) entities. Section 501(m) was inserted in the 1986 Tax Act for the purpose of depriving Blue Cross/Blue Shield organizations of their federal tax exemptions.[7] That section provides that "An organization described in . . .

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[4] This statement is based upon the 2001 census, which reports that the population of the United States of America is 284,796,887.

[5] Cantilo & Bennett, at 78 (emphasis added).

[6] Cantilo & Bennett, at 2.

[7] "Reasons for Change. The committee is concerned that exempt charitable and social welfare organizations that engage in insurance activities are engaged in an activity whose nature and scope is so inherently commercial that tax-exempt status is inappropriate." . . . "[T]he availability of tax-exempt status

[section 501(c)(3) or 501(c)(4) of the Internal Revenue Code] . . . shall be exempt from tax . . . only if no substantial part of its activities consists of providing commercial-type insurance."

From 1987 forward, the Blue Cross/Blue Shield organizations were required to pay federal corporate income tax, with some softening of the blow through the benefit of section 833 of the Internal Revenue Code.[8] During the 1980s, tax-exempt hospitals and HMOs were being converted in growing numbers. They and the traditional for-profit health insurers had access to the capital markets to build their businesses. The Blue Cross/Blue Shield plans could not compete on a level playing field with their non-Blue competitors because BCBSA did not permit its licensees to organize as for-profit corporations. Thus, the Blue Cross/Blue Shield plans had the worst of both worlds: they were taxable on one hand, and they had no access to capital markets on the other. When BCBSA changed its rules in 1994 to permit licensees to be for-profit companies, it did so not to "cash in" on the franchise. It did so to provide a more level competitive playing field where its members would have the same access to capital as their non-Blue competitors. Billions of dollars in assets previously locked up in nonprofit corporations have been released to philanthropy to serve the unmet health needs of America as a consequence of permitting Blue Cross/Blue Shield plans to become publicly held for-profit companies.

3. *The Proposed Conversion Transaction Is Designed to Deliver the Greatest Dollars to the Charitable Organizations.*

In this proposal, as in many other past proposals to convert a nonprofit entity to for-profit status, the structure of the Proposed Transaction will maximize the potential economic benefit to charity. Taxes incurred in the process of realizing the value of the initial stock of New PREMERA issued to the Foundation Shareholder and transferring the proceeds to the Charitable Organizations will be minimized. The use of a 501(c)(4) organization as the Foundation Shareholder will facilitate the transaction and the ultimate realization of the maximum value for charity. This will be accomplished both by reducing taxes and by providing more transactional flexibility than would be available if a 501(c)(3) organization received the New PREMERA stock.

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under present law has allowed some large insurance entities to compete directly with commercial insurance companies. For example, the Blue Cross/Blue Shield organizations historically have been treated as tax-exempt organizations described in Sections 501(c)(3) or 501(c)(4). This group of organizations is now among the largest health care insurers in the United States." H.R. Rep. No. 426, 99th Cong., 1st Sess., at 664 (1985).

[8] "In the case of activities of Blue Cross and Blue Shield and their affiliates with respect to high risk individuals and small groups, the bill authorizes the Treasury Department to issue regulations providing for special treatment to such organizations. Congress intends that this special benefit be provided in connection with the unique activities (such as open enrollment) of Blue Cross and Blue Shield and their affiliates for high risk individuals and small groups, so that such activities (to the extent not engaged in by commercial insurers) are not overburdened by tax costs and therefore reduced." H.R. Rep. No. 426, 99th Cong., 1st Sess., at 665 (1985).

Organizations recognized as tax-exempt under 501(c)(4) have the disadvantage that they may not receive tax-deductible contributions. However, as social welfare organizations they are not subject to the excise tax "private foundation rules" contained in sections 4940-4948 of the Internal Revenue Code. The use of a 501(c)(4) organization as the Foundation Shareholder will greatly facilitate the Conversion Transaction and the ultimate delivery of the maximum endowment to the Charitable Organizations. Premera proposes to accomplish this flexibility and the saving of over $100 million for charity in the following ways[9]:

No gain taxed on the conversion. The Conversion Transaction itself is described as a combination of tax-free transactions under section 351 of the Internal Revenue Code and section 368(a) of the Internal Revenue Code so that no gain or loss will be recognized on the conversion itself.[10] PwC comments that it is "not . . . unreasonable" for PREMERA to rely on the tax opinion of Ernst & Young that the Conversion Transaction "will" be treated as a series of tax-free transactions for federal income tax purposes.[11] As PwC points out, unless the transactions are tax-free, gain would be recognized by Premera on the conversion (prior to the sale of the initial stock issued to Foundation Shareholder) and would be taxed at federal corporate tax rates.

No gain taxed on the receipt or sale of stock. The initial stock of New PREMERA issued to the Foundation Shareholder will be transferred to an organization that will be recognized by the Internal Revenue Service as exempt from taxation as a "social welfare" organization described in section 501(c)(4) of the Internal Revenue Code. The Foundation Shareholder will not be taxed upon the receipt of the stock. The Foundation Shareholder will hold the New Premera stock with a cost basis of zero. However, because it will be a tax-exempt entity, the Foundation Shareholder will recognize no gain or loss upon the sale of New Premera stock. Thus, there would be no tax on the receipt or sales of the stock.

Cantilo & Bennett suggest that Premera should pay "its fair market value to the Foundation Shareholder in cash on the effective date of the Transaction."[12] They do not discuss the tax, licensing, or other obstacles to this proposal.

No 2% federal excise tax on sale of stock. Any 501(c)(3) organization that is not classified as a "public charity" under section 509(a) of the Internal Revenue Code is a "private foundation" and as such is subject to excise taxes under the "private

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[9] This discussion addresses only federal tax issues, and does not address any issues under the state tax laws of Washington or Alaska.

[10] Section 351 of the Internal Revenue Code provides for the-tax free "organization" of a corporation, and section 368(a) provides for the tax-free "reorganization" of a corporation.

[11] PwC Tax Report, at 3.

[12] Cantilo & Bennett executive summary, at 12; Cantilo & Bennett, at 103, 115.

foundation rules" contained in sections 4940-4948 of the Internal Revenue Code. Section 4940 imposes a tax of 2% on the investment income of 501(c)(3) private foundations. Because the Foundation Shareholder will be a 501(c)(4) social welfare organization, rather than a 501(c)(3) private foundation, it will not be subject to the excise tax under section 4940 of the Internal Revenue Code. If the net proceeds from the sale of the initial stock are over $500 million, using a 501(c)(4) organization as the Foundation Shareholder will increase the funds for the Charitable Organizations by over $10 million by eliminating the section 4940 excise taxes.

Whether there will be a 2% excise tax on the sale of stock will be known at the time Foundation Shareholder receives its recognition letter from the Internal Revenue Service. If it is recognized as a 501(c)(4) organization, it will not incur the tax under section 4940.

No federal excise tax on "excess business holdings." A 501(c)(3) Foundation Shareholder would be subject to the excess business holdings rule contained in Internal Revenue Code section 4943 requiring divestiture of most of the New PREMERA stock within five years. Section 4943 of the private foundation rules imposes an excise tax on "excess business holdings" of a private foundation.[13] Under this section, the Foundation Shareholder would have five years (with a possible extension of another five years) within which to reduce its holdings in PREMERA to less than 20% or pay a substantial annual excise tax on the "excess holdings."

In order to comply with licensing requirements of the BCBSA, Premera will also require the Foundation Shareholder to agree to a schedule for selling its New PREMERA shares. The Voting Trust and Divestiture Agreement contains a provision that the Foundation Shareholder must sell down its holdings from an initial 100% of the Stock of New Premera. Under the agreement, it must reduce its holdings to 80% or less in one year, 50% or less in three years, 20% or less in five years, and 5% or less in six years (with some possibility of one year extensions). While more flexibility might be advisable in the early period so that sales in an unfavorable market will not be required, the schedule of divestitures should be generally aligned with the directors' desire to generate funds for the Charitable Organizations. Both section 4943 of the Internal Revenue Code and the Voting Trust and Divestiture Agreement would require a reduction in Foundation Shareholder's holdings over time. By being a 501(c)(4) organization, the Foundation Shareholder will gain freedom from the Internal Revenue Code sell-down requirement, thus eliminating the risk of incurring an excise tax if the schedule cannot be met.

No federal excise tax on performance of agreements related to stock ownership and sale. Section 4941 of the Internal Revenue Code limits certain transactions

[13] Internal Revenue Code section 4943(c). In general, the private foundation and all disqualified persons are permitted to hold in the aggregate 20% of the voting shares of the company.

between private foundations and their "substantial contributors." Transactions proscribed by the section cause both parties to the transaction to be subject to stiff excise taxes. If it issued 100% of its stock to a 501(c)(3) Foundation Shareholder, New PREMERA would probably be a "substantial contributor" and thus treated as a "disqualified person" subject to section 4941. The kinds of transactions prohibited by section 4941 (with some exceptions) include, for example: "sale or exchange, or leasing, of property between a private foundation and a disqualified person;" and "lending of money or other extension of credit between a private foundation and a disqualified person; . . . ."[14] Were the Foundation Shareholder subject to the prohibitions contained in Internal Revenue Code section 4941, the application of that section would inhibit flexibility in disposition of the New PREMERA stock by the Foundation Shareholder. In particular, various provisions of the Registration Rights Agreement, such as the Purchase Option, would not be permissible. This is one of the reasons that 501(c)(4) organizations have been the holders of the initial stock in some other conversion transactions.

No federal excise tax based upon 5% minimum distribution requirement for the Foundation Shareholder. Section 4942 of the Internal Revenue Code imposes a minimum distribution requirement on 501(c)(3) private foundations. Generally speaking, this section requires annual charitable distributions in the amount of 5% of the investment assets of the foundation. A 501(c)(3) Foundation Shareholder would be subject to the 5% distribution requirement; there is no such distribution requirement imposed on a 501(c)(4) organization. As a 501(c)(4) organization, the Foundation Shareholder's assets will be primarily the New PREMERA shares. It will not be required by the Internal Revenue Code to make charitable distributions from those shares. In the proposed structure, the distribution obligation of the Foundation Shareholder is a contractual obligation to distribute net proceeds of the sale of New PREMERA shares to the Charitable Organizations within thirty days after receipt. Once the cash is received by the 501(c)(3) Charitable Organizations, they will be subject to the 5% distribution requirement of section 4942 of the Internal Revenue Code.

Preservation of beneficial tax attributes for New PREMERA. Premera has stated that it will endeavor to preserve for New PREMERA the tax attributes currently available under sections 833 and 382 of the Internal Revenue Code. If this effort is successful, there will be an additional economic benefit. The net income, and consequently the value of the stock held by the Foundation Shareholder, should be enhanced.

Conversion Transaction is not "too complex." PwC suggests that the plan is too complex.[15] Actually, the plan is only slightly more complex than routine conversion

[14] Internal Revenue Code section 4941(d)(1).

[15] PwC Tax Report, Exhibit 1, at E-4.

transactions. Premera has added two elements to the more common structure: (1) the creation of for-profit subsidiaries of the nonprofit corporations and the subsequent contribution of their shares to parent corporations and dissolution of the nonprofits; and (2) the use of a 501(c)(4) social welfare organization as the Foundation Shareholder with responsibilities for managing the holding and sale of the initial New PREMERA shares in addition to its other continuing social welfare purposes.

Premera has proposed the former because it believes this is the way in which to accomplish the conversion under Washington law. Some other states permit conversions by merely amending the articles of incorporation. The 501(c)(4) social welfare organization has been proposed to manage the sale of the initial New PREMERA shares. If the Foundation Shareholder were a 501(c)(3) organization, there would be an additional $10 million or more in excise taxes payable. The potential tax savings, and the resultant increased amount of cash available to the Charitable Organizations, more than justify any slight additional administrative complexity.

4. The Proposed Conversion Transaction Structure is Workable.

Lobbying by the Foundation Shareholder is Consistent with the "Public Interest." The Conversion Transaction set forth in the documents filed with the Form A reflects the intention of Premera to create the Foundation Shareholder as a 501(c)(4) organization that has the power to conduct lobbying as a part of its social welfare mission. Cantilo & Bennett assert that the "public interest" is "probably not best served" by permitting the Foundation Shareholder to lobby.[16] In framing the exemption from taxation for social welfare organizations, Congress specifically omitted the restrictions on lobbying contained in section 501(c)(3) of the Internal Revenue Code. Attempting to influence legislation, as a part of a health policy agenda, is a recognized and respected function.

Cantilo & Bennett also argue that there will be a conflict of interest between New PREMERA and the Foundation Shareholder and Charitable Organizations because New PREMERA will control the selection of the board members and the Foundation Shareholder will be authorized to engage in lobbying.[17] Notwithstanding New PREMERA's role in selection of the Foundation Shareholder board members, lobbying by the Foundation Shareholder does not create a conflict of interest so long as it is not supported by the proceeds of the sale of stock. The Form A documents preclude the use of funds from the disposition of the initial New PREMERA shares for lobbying.[18]

[16] Cantilo & Bennett, at 43.

[17] Cantilo & Bennett, at 97, 114-115.

[18] Stock Restrictions Agreement (Form A, Exhibit G-3), section 1.02(a).

Lobbying by the Foundation Shareholder does not violate the "public interest." It will have the incidental benefit of saving perhaps $10 million in excise taxes on the sale of the initial New PREMERA stock by the Foundation Shareholder.

<u>**The Assets of Premera are not "Charitable" or "Public Assets."**</u> The assets of Premera are not "charitable" or "public assets." PREMERA is organized as a Washington miscellaneous nonprofit corporation.[19] As such, it may have any lawful purpose not restricted to corporations organized under other statutes.[20] Its Articles of Incorporation state that its purpose is "to manage . . . activities of . . . Blue Cross and Blue Shield licensed plans . . . ."

PBC is organized as a Washington nonprofit corporation.[21] As a Washington nonprofit corporation, its purpose is not required to be "charitable." A broad range of purposes, including "commercial," industrial," and "health care services," is permissible.[22] The Articles of Incorporation of PBC state that its purpose is to "engage in health care services . . . ."

Neither PREMERA nor PBC has ever been a 501(c)(3) charity. PBC was qualified as a 501(c)(4) social welfare organization for federal tax purposes until 1987 with the enactment of section 501(m) of the Internal Revenue Code. PREMERA, which was incorporated in 1994, has always been a taxable corporation. There is no necessity for Premera to subject its current assets as it is now organized to a charitable trust in order to put forward a proposal that at the closing of the Conversion Transaction and the sale of the New PREMERA stock the resulting sale proceeds will be held by charitable entities.

Throughout their report Cantilo & Bennett make the claim that Premera's assets, the New PREMERA stock, or the proceeds of the sale of stock are "public assets," that they are owned by "the public" or by "the citizens" of Washington and Alaska, and that the "settlor" of the Foundation Shareholder is "arguably the public."[23] These claims confuse the analysis of the Commissioner's duties.

Even if the assets of Premera were "charitable" assets at this time, the "public" would not be the owner of Premera.[24] If the assets were charitable assets, for example if

[19] See RCW 24.06.005, et. seq.

[20] RCW 24.06.015.

[21] See RCW 24.03.005, et seq.

[22] RCW 24.03.015.

[23] Cantilo & Bennett executive summary, at 6, 12; Cantilo & Bennett, at 2-3, 16, 39, 45, 109, 114, 115.

[24] One of the risks of considering the assets "public" is exemplified by the experience in the conversion of Empire Blue Cross in New York. Through the efforts of the Governor and labor, most of the assets were diverted from charitable purposes to provide one-time wage increases for certain health care workers. See PwC Tax Report, Exhibit 1, at E-45.

Premera had been organized for charitable purposes, the corporation would "own" the assets subject to a charitable trust. Usually, the Attorney General enforces the charitable trust. The directors of the charitable corporation would be the trustees, and the class who are objects of the charitable purposes stated in the Articles of Incorporation would be beneficiaries of the trust. The beneficial class could be as broad or narrow as "citizens," "residents," "uninsured," "children," "cancer victims," or "undocumented immigrants." Whatever the class of beneficiaries, whether broad or narrow, the members of the class do not have an ownership interest in the assets.

It is often asserted that assets held by a nonprofit corporation must be charitable assets in exchange for the economic benefit of past tax exemptions. This argument is not sound; the obligation to hold assets in a charitable trust flows from the charitable purpose for which the nonprofit corporation was formed, not past tax savings. However, even if this argument were sound, it would not apply to Premera because Premera is taxable for both federal and state purposes.

The Agreements Relating to the Stock of New PREMERA are Similar to Those Customary in Blue Cross/Blue Shield Conversion Transactions. The Conversion Transaction includes a series of agreements between and among New PREMERA, the Foundation Shareholder, a voting trustee, and the Charitable Organizations. These include the Stock Restrictions Agreement, the Voting Trust and Divestiture Agreement, the Registration Rights Agreement, the Stockholder Protection Rights Agreement, the Excess Share Escrow Agent Agreement, the Indemnification Agreement, and the BCBSA License Addendum. Many, but not all, of the restrictions contained in these agreements flow from BCBSA conditions for permitting BCBSA licenses to be held by for-profit corporations. Those restrictions have appeared in one form or another in other Blue Cross/Blue Shield conversion transactions. Most were contained in the Blue Cross of California transaction and did not materially impede either the operations of the charities created in the transaction or the success in creating wealth for the charities by selling the WellPoint shares.

Prior to 1994 all BCBSA licensees were required to be nonprofit organizations. The BCBSA was reluctant to permit for-profit corporations to be licensees, because it wanted to maintain the nature and quality of the Blue Cross/Blue Shield plans and to avoid their takeover by large for-profit insurance companies that might have a very different business model. Thus, many of the restrictions are explicitly intended to keep the existing nonprofit management in place after the conversions. These have included: limitations on voting rights; control over the selection of the majority of the board of the recipient of the stock of the converted entity; limitations on the amount of shares that may be owned by "institutional" investors and "non-institutional" investors; and requirements that the stock received in the conversion be divested over time so that the recipient would not remain a major stockholder.

At the closing of the Conversion Transaction, the initial shares of New PREMERA will be placed in a voting trust under the Voting Trust and Divestiture Agreement. Blackstone notes several concerns with the Voting Trust and Divestiture Agreement:

- the Trustee is required to vote with the Independent Board Majority in most circumstances;

- the Foundation Shareholder would not have any representation on Premera's board;

- Premera is required to consult with the Foundation Shareholder on change in control transactions only if the Foundation Shareholder then owns at least 50% of the outstanding stock.[25]

BCBSA restrictions such as these preserve the independence of the boards of directors of its licensees from large controlling shareholders. The lack of interlocking directorates has been a common feature of the Blue Cross and Blue Shield conversion transactions. Even when some board participation has been permitted, it has been nominal and does not permit the Foundation Shareholder to control the company.

Cantilo & Bennett assert that the Registration Rights Agreement "undermines the public interest" by giving PREMERA control over various aspects of a public offering of its stock. It would be very unusual for a company to give shareholders unrestricted control of the registered offering and sale of its securities. For the most part, the interest of the company and the Foundation Shareholder are aligned in that each wants to maximize the price of the stock in a stable market.

Coupled with the requirement that the Foundation Shareholder will divest its shares over a relatively short period of years, and the limitations on any share ownership in excess of 5% or 10% for other shareholders, these requirements are intermediate steps on the transitional path of New PREMERA from nonprofit status toward its existence as a widely held public company with no controlling shareholder.

In California, as the years after the 1996 conversion of nonprofit Blue Cross of California into for-profit WellPoint unfolded, none of these kinds of restrictions created significant problems. Until the bulk of the WellPoint stock had been sold, former directors of Blue Cross of California were required to hold the majority of seats on the board of California HealthCare Foundation, the 501(c)(4) foundation that received the initial WellPoint stock in the conversion. The foundation directors quickly established themselves as independent of WellPoint and recognized that their fiduciary duty was to California HealthCare Foundation. Most of the shares were placed in a voting trust with terms similar to those found in the proposed Conversion Transaction. Demand and "piggy back" stock registration rights were governed by an

[25] Blackstone at 10, 52-53.

agreement similar to the Registration Rights Agreement in the Conversion Transaction. The disposition of the WellPoint stock held by the foundation occurred smoothly over the first five years after the conversion was closed.

Restrictions in the Transaction Agreements Will Not Necessarily Reduce the Value of the Assets going to Charity. Cantilo & Bennett assert that the restrictions contained in various agreements among and between Premera, the Foundation Shareholder and the Charitable Organizations "may prevent the Foundation Shareholder, or the proposed Charitable Organizations, from receiving PREMERA's fair market value."[26] Their concept seems to be that the enterprise, though it is a BCBSA licensee, has a value independent of the license terms, and that the license restrictions take a part of that value away from the "public." Premera proposes to transfer 100% of the initial stock of New PREMERA to the Foundation Shareholder on the day the Conversion Transaction closes. The BCBSA license restrictions are inherent in the business, inherent in operating as a licensee and linked to the commercial benefit of the right to use the name and mark. Even if there were a charitable trust imposed on its assets, Premera would not have an obligation to transfer any more than the entire enterprise to charity.

The Registration Rights Agreement includes purchase options giving New PREMERA the right to purchase shares from the Foundation Shareholder under certain conditions. Blackstone notes that many past transactions did not include a Company Purchase Option.[27] One possible reason for the omission of the repurchase option from certain Blue Cross/Blue Shield transactions is that for conversions occurring after the 1986 enactment of section 501(m), where a 501(c)(4) entity was not the recipient of the stock, a Company Repurchase Option could be prohibited under section 4941 of the Internal Revenue Code.[28]

Cantilo & Bennett say the Purchase Options deprive the Foundation Shareholder of investment flexibility and "may" undermine the value of the stock.[29] If the purchase option is exercised after an IPO, the option price is based upon the market price prior to the Foundation Shareholder's registration demand. In that case the Foundation Shareholder should be assured of receiving a fair price and the option should not "undermine the value of the stock."

Cantilo & Bennett argue that the transfer of voting rights will reduce the Foundation Shareholder's "ability to optimize the value of the charitable assets." The restrictions should not affect the price that will be obtained by the Foundation Shareholder for New PREMERA's shares, because the restrictions will not bind the purchasers of

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[26] Cantilo & Bennett, at 23 (emphasis edded).

[27] Blackstone, at 12.

[28] Treas. Reg. section 1-507(d)-2.

[29] Cantilo & Bennett executive summary, at 12; Cantilo & Bennett, at 17, 115-116.

those shares. The value to the purchaser should not be affected by the fact that the Foundation Shareholder previously held the shares subject to restrictions.

Some Revisions Suggested by the OIC Consultants are Problematic. There is a suggestion that the IPO should be closed on the date the Conversion Transaction is given regulatory approval, or on the day the Conversion Transaction is closed. This may create some complex issues:

- How can the SEC registration process be completed if the regulatory approvals have not been given?
- If the regulatory approval is conditional, how can the conditions be met on the day the order is made?
- In what way can the OIC and the ADI take market conditions into account so as to assure that they approve the Conversion Transaction when market conditions are most conducive to a successful IPO?

Another suggestion in the reports is that there be two Foundation Shareholders, one each for Alaska and Washington.[30] The consultants do not discuss the potential problems that might be created for the two Foundation Shareholders and for New PREMERA if there were conflicting demands for registration or the need to cut back the allocations of competing Foundation Shareholders in a stock offering. Disorderly lack of coordination in the sale of stock could result in dampening the value of the stock to the detriment of both Charitable Organizations.

Divestiture Provisions are Customary in Blue Cross/Blue Shield Conversions and are Consistent with Ultimate Diversification of Charitable Assets. The divestiture provisions require the Foundation Shareholder to sell its PREMERA stock on a schedule: reducing its holdings to less than 80% in one year, 50% in three years, 20% in five years, and 5% in six years. Some extensions are permitted. Even without a schedule, there would be reasons for the sale of stock. The Charitable Organizations will be in a position to begin to diversify and to commence grant making in the community only when sale proceeds flow to them. Until a significant amount of stock is in the hands of public shareholders, the market in New PREMERA shares may be depressed by the Foundation Shareholder's ownership of such a large portion of the shares. The directors of the Foundation Shareholder and their financial advisors will need to balance factors such as market overhang, the need to sell so that the Charitable Organizations can fund their endowment, diversify investments, and fund operations, as well as divestiture requirements and the current condition of the market, in deciding when and how much New PREMERA stock to sell.

[30] Cantilo & Bennett, at 13, 44.

<u>Indemnity Agreements are Customary in Blue Cross/Blue Shield Conversions</u>. The Indemnity Agreement is similar to those in other Blue Cross/Blue Shield conversion transactions. Blackstone, PwC and Cantilo & Bennett all question the Indemnity Agreement. If one of the events that would trigger an indemnity occurs while the Foundation Shareholder owns shares of New PREMERA, the Foundation Shareholder will suffer a loss of value, either (i) if there were no indemnity through a decline in the value of its portion of the outstanding stock, or (ii) if there were an indemnity through a requirement that it respond to the indemnity. The question is not whether Foundation Shareholder should have exposure. Rather, it is whether the exposure should be limited to its proportional ownership in the company.

At the time of the IPO, the market will assess the risks covered by the indemnity. The largest apparent potential risk, that gain will be recognized on the Conversion Transaction, seems remote given the tax opinions Premera will obtain. To the extent the market places a value on the potential risk, that value may be reflected in the price the Foundation Shareholder obtains on the sale of its stock. This may cause the price realized with the indemnity in place to be greater than that if there were no Indemnity Agreement. It will, however, mean that the risk will be borne by the Foundation Shareholder alone rather than all of the then shareholders of New PREMERA including the Foundation Shareholder. If there is to be an Indemnity Agreement, the Foundation Shareholder may wish to obtain a tax opinion on the issues for which it agrees to indemnify Premera and its affiliates.

5. *<u>The Proposed Conversion Transaction is Superior to Alternatives Considered by PwC</u>.*

PwC discusses alternative structures for achieving some, but not all, of the objectives of the Conversion Transaction.[31] Compared to these alternatives, the currently proposed two-tier plan Conversion Transaction is more practical and efficient.

<u>OPTION 1: The Current Two-Tier Plan</u>. PwC acknowledges that the "two tier" plan proposed by Premera is unique among Blue Cross/Blue Shield conversion transactions. PwC recognizes the benefits of the unique plan. It observes that under the current plan, the Foundation Shareholder will not incur the 2% excise tax on investment income on the sale of New PREMERA stock. It also states that the plan will have the benefit that the Foundation Shareholder may "receive and manage the monetization of the New Premera shares."[32]

PwC's chief concern with the current plan seems to be the possibility that the Foundation Shareholder might be recognized by the Internal Revenue Service only as a 501(c)(3) entity subject to the 2% excise tax on its investment income, including

[31] PwC Tax., Exhibit 1, at E-36, et seq.

[32] PwC Tax., Exhibit 1, at E 32.

gain on the sale of the PREMERA shares, rather than as a 501(c)(4) entity. This concern seems to be based upon the model in some other conversion transactions. In those, a 501(c)(4) organization is the long term charitable grant-making entity and has a corporate charter and bylaws that incorporate provisions mimicking the private foundation rules in Internal Revenue Code sections 4940-4948. Such an organization might be recognized as tax-exempt under either 501(c)(3) or 501(c)(4).

Because it will not be the permanent charitable grant-making entity, the Foundation Shareholder will not have the full set of quasi-private foundation rule provisions in its charter and bylaws. The Foundation Shareholder will have a broad social welfare mission stated in its articles of incorporation.[33] It will carry out a longer-range health policy mission that will include substantial lobbying activity. No substantial part of the activities of a section 501(c)(3) charity may be lobbying, and a 501(c)(3) private foundation may not lobby at all without incurring an excise tax under Internal Revenue Code section 4945. Thus, the fact that the Foundation Shareholder social welfare organization will have a health policy agenda that includes substantial lobbying will disqualify it from being a 501(c)(3) organization. PwC also makes useful suggestions about expanding the social welfare mission of the Foundation Shareholder to assure its recognition as a 501(c)(4) entity.[34]

Even if the Foundation Shareholder were organized in a way that would make it eligible to be recognized as either a 501(c)(3) or a 501(c)(4) entity, PwC does not indicate that the Internal Revenue Service has ever <u>retroactively</u> revoked its recognition of an organization as a 501(c)(4) entity and treated it as a 501(c)(3) entity.

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[33] "[The] Corporation's specific purposes are to promote the health of the residents of the states of Washington and Alaska by: . . .

a) improving the availability of quality, affordable health care and related services;

b) addressing the unmet health care needs of uninsured and underinsured populations;

c) supporting the education of health care providers to increase the number of active physician and non-physician providers and developing more efficient and effective health care delivery models;

d) supporting programs of medical, surgical and other scientific research aiming to (i) make health care delivery more comprehensive and flexible, and (ii) develop and promote the most efficient uses of health care facilities, resources and services;

e) supporting initiatives to address short and long-term public health care needs and concerns;

f) providing grants and establishing programs to carry out such purposes;

g) lobbying and otherwise attempting to influence legislation that promotes the efficient use of health care resources by simplifying and reducing the administrative burdens of health care providers and Health Insurers in Washington and Alaska; and

h) otherwise serving the health care needs of residents of the states of Washington and Alaska."

[34] PwC Tax, Exhibit 1, at E-38.

<u>OPTION 2: One Tier with Two, Section 501(c)(4), Social Welfare Organizations</u>. PwC considered a model of eliminating the "middleman" section 501(c)(4) organization and issuing PREMERA stock directly to two 501(c)(4) entities rather than 501(c)(3) private foundations.[35] PwC notes that this structure would eliminate both the ongoing excise tax on investment income under Internal Revenue Code section 4940 and minimum distribution requirements under Internal Revenue Code section 4942.

The drawbacks identified by PwC for this type of transaction are that it might be difficult to obtain recognition for the organizations as 501(c)(4) entities if their Articles and bylaws contained analogs of the private foundation rules, and that it would restrict the ability of the organizations to receive foundation and government grants in the future.

With regard to the former drawback, i.e., difficulty in obtaining 501(c)(4) recognition from the Internal Revenue Service, if quasi-private foundation rules have been embedded in the corporate charter and bylaws, PwC seems to believe that this might cause difficulty in obtaining recognition of the Foundation Shareholder as a 501(c)(4) rather than a 501(c)(3) organization.[36] In OPTION 1 above, the articles and bylaws of the Foundation Shareholder do not need to contain all of the quasi-private foundation rule provisions, because the Foundation Shareholder will not be charged with the long term charitable grant-making mission. Its longer-term mission is a social welfare mission related to health policy. Thus, the two-tier structure is preferable to a one-tier structure using two 501(c)(4) entities as the charitable organizations.

As to the latter drawback PwC observes, "[T]he possibility of future donations is remote."[37] Most charities created in health care conversion transaction are grant-making organizations. Although there is no prohibition on their seeking additional contributions, most do not seek further foundation or governmental funding. To the extent that they seek to supplement their funding capability, they usually do so through program partnerships with other foundations or government agencies.

<u>OPTION 3: One Tier with Two, Section 501(c)(3), Private Foundations</u>. PwC also explored the alternative of eliminating the "middleman" 501(c)(4) organization and issuing PREMERA stock directly to the two Charitable Organizations as 501(c)(3) private foundations.[38] They suggest that this will reduce the "cost and

[35] PwC Tax, Exhibit 1, at E-10 and E-36

[36] PwC Tax, Exhibit 1, at E-11.

[37] PwC Tax, Exhibit 1, at E-36.

[38] PwC Tax, Exhibit 1, at E-11 and E-37.

complexity" of the transaction and would be easier to explain to the public.[39] The benefits would come at high costs.

The excise tax of Internal Revenue Code section 4940 would be incurred on the sale of stock by a 501(c)(3) entity as well as on its annual income from investment assets. Over time this cost could be tens of millions of dollars. Furthermore, the 5% distribution requirement of Internal Revenue Code section 4942 would be applicable even during the time the Charitable Organizations' assets were comprised wholly or largely of New PREMERA stock, which is unlikely initially to pay dividends sufficient to meet the 5% payout requirement. The restrictions contained in section 4941 of the Internal Revenue Code could also hamper flexibility in the sale and disposition of the initial New PREMERA shares. Using only 501(c)(3) charitable entities is not advisable.

[39] PwC Tax, Exhibit 1, at E-12.